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SUNAIR ELECTRONICS INC
Form 10QSB
August 16, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2004

OR

TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

Commission file number I-4334

SUNAIR ELECTRONICS, INC.

(EXACT NAME OF SMALL BUSINESS ISSUER AS SPECIFIED IN ITS CHARTER)

FLORIDA

(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)

3005 SW THIRD AVE., FT. LAUDERDALE, FL.

(ADDRESS OR PRINCIPAL EXECUTIVE OFFICE)

ISSUER'S TELEPHONE NUMBER (INCLUDING AREA CODE)

NONE

(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR,
IF CHANGED SINCE LAST REPORT)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Registrant's common stock - par value 10 cents, outstanding as of August 16, 2004 - 4,006,620 shares.

Transitional Small Business Disclosure format. Yes No

SUNAIR ELECTRONICS, INC. AND SUBSIDIARY

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PART I. FINANCIAL INFORMATION

SUNAIR ELECTRONICS, INC. AND SUBSIDIARY CONSOLIDATED CONDENSED BALANCE SHEETS (UNAUDITED)

	06/30/04	9/30/03
ASSETS	-----	-----
CURRENT ASSETS:		
Cash and cash equivalents	\$ 1,684,526	\$ 1,022,175
Accounts receivable	1,297,293	1,768,772
Interest receivable	155,784	108,510
Inventories	6,906,744	7,053,241
Short term investments	2,001,190	1,500,000
Prepaid and other current assets	31,577	20,008
	-----	-----
Total Current Assets	12,077,114	11,472,706
INVESTMENTS	2,966,878	2,988,383

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NOTE RECEIVABLE	334,986	334,986
PROPERTY, PLANT, AND EQUIPMENT, net	585,881	681,095
	-----	-----
TOTAL ASSETS	\$15,964,859	\$15,477,170
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	\$ 357,281	\$ 611,458
Income taxes payable	--	219,959
	-----	-----
Total Current Liabilities	357,281	831,417
INCOME TAXES PAYABLE, net of current portion	--	122,000
STOCKHOLDERS' EQUITY:		
Preferred stock, no par value, 2,000,000 shares authorized, none issued and outstanding	--	--
Common stock, \$.10 par value, 25,000,000 shares authorized, 3,816,620, and 3,738,170 shares issued and outstanding at June 30, 2004 and September 30, 2003, respectively	381,662	373,817
Additional paid-in-capital	2,873,606	2,704,939
Retained earnings	12,352,310	11,444,997
	-----	-----
Total Stockholders' Equity	15,607,578	14,523,753
	-----	-----
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$15,964,859	\$15,477,170
	=====	=====

The accompanying notes are an integral part of these financial statements

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CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(UNAUDITED)

	NINE MONTHS ENDED	
	06/30/04	06/30/03
	-----	-----
SALES	\$ 5,951,143	\$ 3,436,094
COST OF SALES	3,284,769	2,000,778
	-----	-----
GROSS PROFIT	2,666,374	1,435,316
SELLING, GENERAL & ADMINISTRATIVE EXPENSES	1,557,428	1,268,095
	-----	-----

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OPERATING INCOME	1,108,946	167,221
OTHER INCOME:		
INTEREST INCOME	189,488	219,718
OTHER, NET	(19,021)	9,710
	-----	-----
INCOME BEFORE PROVISION FOR INCOME TAXES	1,279,413	396,649
PROVISION FOR INCOME TAXES	(372,100)	(140,300)
	-----	-----
NET INCOME	\$ 907,313	\$ 256,349
	=====	=====
NET INCOME PER SHARE:		
BASIC	\$ 0.24	\$ 0.07
	=====	=====
DILUTED	\$ 0.23	\$ 0.07
	=====	=====
WEIGHTED AVERAGE SHARES OUTSTANDING:		
BASIC	3,797,004	3,693,797
	=====	=====
DILUTED	3,885,942	3,758,856
	=====	=====

The accompanying notes are an integral part of these financial statements

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CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(UNAUDITED)

	THREE MONTHS ENDED	
	06/30/04	06/30/03
	-----	-----
SALES	\$ 1,420,687	\$ 1,135,355
COST OF SALES	765,750	647,780
	-----	-----
GROSS PROFIT	654,937	487,575
SELLING, GENERAL & ADMINISTRATIVE EXPENSES	527,254	376,191
	-----	-----
OPERATING INCOME	127,683	111,384
OTHER INCOME:		
INTEREST INCOME	65,005	54,148
OTHER, NET	(14,976)	26,960
	-----	-----
INCOME BEFORE PROVISION FOR INCOME TAXES	177,712	192,492
PROVISION FOR INCOME TAXES	(63,500)	(68,500)
	-----	-----

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NET INCOME	\$ 114,212	\$ 123,992
	=====	=====
NET INCOME PER SHARE:		
BASIC	\$ 0.03	\$ 0.03
	=====	=====
DILUTED	\$ 0.03	\$ 0.03
	=====	=====
WEIGHTED AVERAGE SHARES OUTSTANDING:		
BASIC	3,816,620	3,696,251
	=====	=====
DILUTED	3,905,854	3,751,310
	=====	=====

The accompanying notes are an integral part of these financial statements

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CONSOLIDATED CONDENSED STATEMENT OF CASH FLOWS
(UNAUDITED)

	NINE MONTHS ENDED	
	06/30/04	06/30/03
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME	\$ 907,313	\$ 256,349
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
DEPRECIATION	118,396	103,406
AMORTIZATION	21,505	21,505
(INCREASE) DECREASE IN ASSETS:		
ACCOUNTS RECEIVABLE	471,479	(287,447)
INTEREST RECEIVABLE	(47,274)	79,557
INVENTORIES	146,497	(1,628,443)
PREPAID AND OTHER CURRENT ASSETS	(11,569)	(32,244)
INCREASE (DECREASE) IN LIABILITIES:		
ACCOUNTS PAYABLE AND ACCRUED EXPENSES	(254,177)	189,530
INCOME TAXES PAYABLE	(341,959)	(568,709)
	-----	-----
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	1,010,211	(1,866,496)
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
PURCHASE OF PROPERTY, PLANT, AND EQUIPMENT	(23,182)	(50,520)
PURCHASES OF INVESTMENTS	(501,190)	81,877
	-----	-----
NET CASH USED IN INVESTING ACTIVITIES	(524,372)	31,357
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
EXERCISE OF STOCK OPTIONS	176,512	11,250
	-----	-----
NET CASH PROVIDED BY FINANCING ACTIVITIES	176,512	11,250
	-----	-----
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	662,351	(1,823,889)

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CASH AND CASH EQUIVALENTS, AT BEGINNING OF PERIOD	1,022,175	2,422,833
	-----	-----
CASH AND CASH EQUIVALENTS, AT END OF PERIOD	\$ 1,684,526	\$ 598,944
	=====	=====
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
CASH PAID DURING THE YEAR FOR INCOME TAXES	\$ 718,000	\$ 855,000
	=====	=====

The accompanying notes are an integral part of these financial statements

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

1. BASIS OF CONSOLIDATED FINANCIAL STATEMENT PRESENTATION

THE ACCOMPANYING UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS HAVE BEEN PREPARED BY THE COMPANY PURSUANT TO THE RULES AND REGULATIONS OF THE SECURITIES AND EXCHANGE COMMISSION AND IN ACCORDANCE WITH THE INSTRUCTIONS TO FORM 10-QSB AND DO NOT INCLUDE ALL THE INFORMATION AND FOOTNOTE DISCLOSURES NORMALLY INCLUDED IN CONSOLIDATED FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH ACCOUNTING PRINCIPLES GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA. THE INFORMATION FURNISHED IN THE INTERIM FINANCIAL STATEMENTS INCLUDES NORMAL RECURRING ADJUSTMENTS AND REFLECTS ALL ADJUSTMENTS, WHICH, IN THE OPINION OF MANAGEMENT, ARE NECESSARY FOR A FAIR PRESENTATION OF SUCH FINANCIAL STATEMENTS. FOR FURTHER INFORMATION REFER TO THE CONSOLIDATED FINANCIAL STATEMENTS AND FOOTNOTES THERETO INCLUDED IN THE COMPANY'S MOST RECENT AUDITED CONSOLIDATED FINANCIAL STATEMENTS AND NOTES THERETO INCLUDED IN ITS SEPTEMBER 30, 2003 ANNUAL REPORT ON FORM 10-KSB. OPERATING RESULTS FOR THE NINE MONTHS ENDED JUNE 30, 2004 ARE NOT NECESSARILY INDICATIVE OF THE RESULTS THAT MAY BE EXPECTED FOR THE YEAR ENDING SEPTEMBER 30, 2004.

2. SIGNIFICANT ACCOUNTING POLICIES

USE OF ESTIMATES

THE PREPARATION OF FINANCIAL STATEMENTS IN CONFORMITY WITH ACCOUNTING PRINCIPLES GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA REQUIRES MANAGEMENT TO MAKE ESTIMATES AND ASSUMPTIONS THAT AFFECT THE REPORTED AMOUNTS IN THE CONSOLIDATED FINANCIAL STATEMENTS AND ACCOMPANYING NOTES. ACTUAL RESULTS COULD DIFFER FROM THOSE ESTIMATES.

ACCOUNTS RECEIVABLE

ACCOUNTS RECEIVABLE CONSIST OF BALANCES DUE FROM SALES. THE COMPANY MONITORS ACCOUNTS RECEIVABLE AND PROVIDES ALLOWANCES WHEN CONSIDERED NECESSARY. AS OF JUNE 30, 2004 AND SEPTEMBER 30, 2003 ACCOUNTS RECEIVABLE WERE CONSIDERED TO BE FULLY COLLECTIBLE, ACCORDINGLY NO ALLOWANCE FOR DOUBTFUL ACCOUNTS WAS PROVIDED. IF AMOUNTS BECOME UNCOLLECTIBLE, THEY WILL BE CHARGED TO OPERATIONS WHEN THAT DETERMINATION IS MADE. THE COMPANY HAS LIMITED EXPOSURE TO BAD DEBT AS DOMESTIC SALES ARE PRIMARILY TO THE U.S. GOVERNMENT OR LARGER DEFENSE CONTRACTORS. INTERNATIONAL SALES ARE PRIMARILY CASH IN ADVANCE OF SHIPMENT OR LETTERS OF CREDIT.

INVESTMENTS

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CERTAIN INVESTMENTS THAT MANAGEMENT HAS THE INTENT AND ABILITY TO HOLD TO MATURITY ARE REPORTED AT COST, ADJUSTED FOR AMORTIZATION OF PREMIUMS AND ACCRETION OF DISCOUNTS THAT ARE RECOGNIZED IN INTEREST INCOME USING THE INTEREST METHOD OVER THE PERIOD TO MATURITY.

MARKETABLE AND DEBT SECURITIES WHICH MANAGEMENT HAS CLASSIFIED AS TRADING ARE CARRIED AT FAIR VALUE WITH NET UNREALIZED GAINS AND LOSSES REPORTED IN OPERATIONS. REALIZED GAINS AND LOSSES ON MARKETABLE EQUITY AND DEBT SECURITIES ARE RECOGNIZED UPON SALE USING THE SPECIFIC IDENTIFICATION METHOD.

INVENTORIES

INVENTORIES, WHICH CONSIST OF RAW MATERIALS, WORK-IN-PROCESS, AND FINISHED GOODS, ARE STATED AT THE LOWER OF COST OR MARKET VALUE, COST BEING DETERMINED USING THE FIRST IN, FIRST OUT METHOD. FIXED AND VARIABLE MANUFACTURING COSTS AND OVERHEAD ARE INCLUDED IN THE CARRYING VALUES OF FINISHED GOODS AND WORK-IN-PROCESS. THE COMPANY RECORDS RESERVES FOR INVENTORY SHRINKAGE AND OBSOLESCENCE, WHEN CONSIDERED NECESSARY. FOR THE NINE MONTHS ENDED JUNE 30, 2004 INVENTORY SHRINKAGE AND OBSOLESCENCE RESERVES INCREASED \$62,607.

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PROPERTY, PLANT, AND EQUIPMENT

PROPERTY, PLANT AND EQUIPMENT ARE CARRIED AT COST. DEPRECIATION IS PROVIDED OVER THE ESTIMATED USEFUL LIVES OF THE ASSETS USING BOTH THE STRAIGHT-LINE AND ACCELERATED METHODS. THE ESTIMATED USEFUL LIVES USED TO COMPUTE DEPRECIATION ARE AS FOLLOWS:

BUILDINGS AND IMPROVEMENTS	10 TO 30 YEARS
MACHINERY AND EQUIPMENT	4 TO 10 YEARS

THE COST OF MAINTENANCE AND REPAIRS IS CHARGED TO EXPENSE AS INCURRED; RENEWALS AND BETTERMENTS ARE CAPITALIZED. WHEN PROPERTIES ARE RETIRED OR OTHERWISE DISPOSED OF, THE COST OF SUCH PROPERTIES AND THE RELATED ACCUMULATED DEPRECIATION ARE REMOVED FROM THE ACCOUNTS. ANY PROFIT OR LOSS IS CREDITED, OR CHARGED TO INCOME.

IMPAIRMENT OF LONG-LIVED ASSETS AND LONG-LIVED ASSETS TO BE DISPOSED OF

THE COMPANY REVIEWS LONG-LIVED ASSETS FOR IMPAIRMENT WHENEVER EVENTS OR CHANGES IN CIRCUMSTANCES INDICATE THAT THE CARRYING AMOUNT OF AN ASSET MAY NOT BE RECOVERABLE. RECOVERABILITY OF ASSETS TO BE HELD AND USED IS MEASURED BY A COMPARISON OF THE CARRYING AMOUNT OF AN ASSET TO FUTURE UNDISCOUNTED CASH FLOWS EXPECTED TO BE GENERATED BY THE ASSET. IF SUCH ASSETS ARE CONSIDERED TO BE IMPAIRED, THE IMPAIRMENT TO BE RECOGNIZED IS MEASURED BY THE AMOUNT BY WHICH THE ASSETS EXCEEDS THE FAIR VALUE. ASSETS TO BE DISPOSED OF ARE REPORTED AT THE LOWER OF THE CARRYING AMOUNT OR FAIR VALUE LESS COSTS TO SELL.

REVENUE RECOGNITION

THE COMPANY AND ITS SUBSIDIARY USE THE ACCRUAL BASIS OF ACCOUNTING. SALES REVENUES ARE RECORDED WHEN PRODUCTS ARE SHIPPED AND TITLE HAS PASSED TO UNAFFILIATED CUSTOMERS. INTEREST AND DIVIDENDS EARNED ON INVESTMENTS ARE RECORDED WHEN EARNED.

FAIR VALUE OF FINANCIAL INSTRUMENTS

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THE CARRYING AMOUNTS OF CASH AND CASH EQUIVALENTS, ACCOUNTS RECEIVABLE, ACCOUNTS PAYABLE AND ACCRUED LIABILITIES, APPROXIMATE FAIR VALUE DUE TO THE SHORT-TERM MATURITIES OF THESE ASSETS AND LIABILITIES. THE FAIR MARKET VALUE OF OTHER FINANCIAL INSTRUMENTS IS PROVIDED BY THE USE OF QUOTED MARKET PRICES AND OTHER APPROPRIATE VALUATION TECHNIQUES, BASED ON INFORMATION AVAILABLE AT YEAR-END.

INCOME TAXES

THE COMPANY ACCOUNTS FOR INCOME TAXES USING SFAS NO. 109, "ACCOUNTING FOR INCOME TAXES", WHICH REQUIRES RECOGNITION OF DEFERRED TAX LIABILITIES AND ASSETS FOR EXPECTED FUTURE TAX CONSEQUENCES OF EVENTS THAT HAVE BEEN INCLUDED IN THE FINANCIAL STATEMENTS OR TAX RETURNS. UNDER THIS METHOD, DEFERRED TAX LIABILITIES AND ASSETS ARE DETERMINED BASED ON THE DIFFERENCE BETWEEN THE FINANCIAL STATEMENT AND TAX BASES OF ASSETS AND LIABILITIES USING ENACTED TAX RATES IN EFFECT FOR THE YEAR IN WHICH THE DIFFERENCES ARE EXPECTED TO REVERSE. A VALUATION ALLOWANCE IS RECORDED FOR DEFERRED TAX ASSETS IF IT IS MORE LIKELY THAN NOT THAT SOME PORTION OR ALL OF THE DEFERRED TAX ASSETS WILL NOT BE REALIZED.

RESEARCH AND DEVELOPMENT

EXPENDITURES FOR RESEARCH AND DEVELOPMENT ARE CHARGED TO OPERATION AS INCURRED.

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3. INVENTORIES

INVENTORIES CONSIST OF THE FOLLOWING

	06/30/04	9/30/03
	-----	-----
MATERIALS	\$1,885,109	\$2,352,471
WORK IN PROGRESS	4,317,208	3,957,855
FINISHED GOODS	704,427	742,915
	-----	-----
	\$6,906,744	\$7,053,241
	=====	=====

4. EARNINGS PER COMMON SHARE -

BASIC EARNINGS PER SHARE AMOUNTS ARE COMPUTED BY DIVIDING THE NET INCOME BY THE WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING. DILUTED EARNINGS PER SHARE AMOUNTS ARE COMPUTED BY DIVIDING NET INCOME BY THE WEIGHTED AVERAGE NUMBER OF SHARES OF COMMON STOCK, COMMON STOCK EQUIVALENTS, AND STOCK OPTIONS OUTSTANDING DURING THE PERIOD.

5. INVESTMENTS -

INVESTMENTS INCLUDE PRIVATE EXPORT FUNDING CORPORATION (PEFCO) NOTES. THESE NOTES ARE GUARANTEED BY THE EXPORT-IMPORT BANK OF THE UNITED STATES, AN AGENCY OF THE UNITED STATES. THE COMPANY HAS CLASSIFIED THESE SECURITIES AS "HELD-TO-MATURITY" SECURITIES, IN ACCORDANCE WITH STATEMENT OF FINANCIAL ACCOUNTING STANDARDS (SFAS) NO. 115, "ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES". HELD-TO-MATURITY SECURITIES ARE RECORDED AT AMORTIZED COST. AMORTIZATION OF RELATED DISCOUNTS OR PREMIUMS IS INCLUDED IN THE DETERMINATION OF NET INCOME.

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6. INCOME TAXES:

DURING 1995, IT WAS DETERMINED THAT CONTINUED OPERATIONS OF ITS INTEREST CHARGE-DOMESTIC INTERNATIONAL SALES CORPORATION (IC-DISC) SUBSIDIARY'S TAX ELECTION WAS NO LONGER ADVANTAGEOUS TO THE COMPANY. ACCORDINGLY, THE TAX ELECTION OF THE SUBSIDIARY WAS DISCONTINUED AND ITS RETAINED EARNINGS OF APPROXIMATELY \$3,200,000 WERE DISTRIBUTED TO THE COMPANY. FEDERAL TAX REGULATIONS PROVIDE FOR THE TAXATION OF SUCH DISTRIBUTION OVER A TEN YEAR PERIOD IN EQUAL ANNUAL INCREMENTS. UTILIZING THE MAXIMUM TAX RATES, THE INCOME TAX CONSEQUENCE OF SUCH DISTRIBUTION WILL APPROXIMATE \$122,000 PER YEAR. NO INTEREST IS PAYABLE ON THIS UNPAID PORTION.

7. PREFERRED STOCK:

AT JUNE 30, 2004, THE COMPANY HAD 2,000,000 AUTHORIZED SHARES OF PREFERRED STOCK, NO PAR VALUE, THAT MAY BE ISSUED AT SUCH TERMS AND PROVISIONS AS DETERMINED BY THE BOARD OF DIRECTORS. NONE ARE OUTSTANDING.

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8. STOCK OPTIONS:

AT THE FISCAL YEAR ENDED SEPTEMBER 30, 2003, OPTIONS TO PURCHASE 270,000 SHARES AT \$2.25 PER SHARE HAD BEEN ISSUED TO KEY EMPLOYEES OF THE COMPANY. ON NOVEMBER 6, 2003, THE COMPANY'S MAJORITY SHAREHOLDER SOLD 1,994,000 COMMON SHARES TO AN UNRELATED THIRD PARTY, WHEREBY THE NEW SHAREHOLDER OWNS APPROXIMATELY 53% OF THE COMPANY. DUE TO THE MAJORITY CHANGE IN OWNERSHIP, ALL OF THE COMPANY'S OUTSTANDING STOCK OPTIONS BECAME FULLY VESTED AND EXERCISABLE ON NOVEMBER 6, 2003. OPTIONS FOR 45,600 WERE EXERCISED IN FISCAL 2003 AND 78,450 WERE EXERCISED IN THE FIRST NINE MONTHS OF FISCAL 2004. 145,950 STOCK OPTIONS ARE CURRENTLY EXERCISABLE. THE OPTIONS GRANTED SHALL BE EXERCISABLE UP TO AND INCLUDING FIVE YEARS FROM THE DATE OF GRANT.

9. RECENT ACCOUNTING PRONOUNCEMENTS

IN NOVEMBER 2002, THE FASB ISSUED INTERPRETATION NO. 45, "GUARANTOR'S ACCOUNTING AND DISCLOSURE REQUIREMENTS FOR GUARANTEES, INCLUDING INDIRECT GUARANTEES OF INDEBTEDNESS OF OTHERS" WHICH EXPANDS PREVIOUSLY ISSUED ACCOUNTING GUIDANCE AND DISCLOSURE REQUIREMENTS FOR CERTAIN GUARANTEES. THE INTERPRETATION REQUIRES AN ENTITY TO RECOGNIZE AN INITIAL LIABILITY FOR THE FAIR VALUE OF AN OBLIGATION ASSUMED BY ISSUING A GUARANTEE. THE INITIAL RECOGNITION AND INITIAL MEASUREMENT PROVISIONS OF FIN NO. 45 ARE APPLICABLE TO A COMPANY ON A PROSPECTIVE BASIS TO GUARANTEES ISSUED OR MODIFIED AFTER DECEMBER 31, 2002. HOWEVER, THE DISCLOSURE REQUIREMENTS IN FIN NO. 45 ARE EFFECTIVE FOR A COMPANY'S FINANCIAL STATEMENTS FOR PERIODS ENDING AFTER DECEMBER 15, 2002. THE COMPANY IS NOT A PARTY TO ANY AGREEMENT IN WHICH IT IS A GUARANTOR OF INDEBTEDNESS OF OTHERS THEREFORE THE INTERPRETATION DID NOT AFFECT THE COMPANY'S FINANCIAL POSITION, RESULTS OF OPERATIONS OR CASH FLOWS.

IN JANUARY 2003, THE FASB ISSUED INTERPRETATIONS NO. 46, "CONSOLIDATION OF VARIABLE INTEREST ENTITIES". FIN NO. 46 ADDRESSES CONSOLIDATION BY BUSINESS ENTERPRISES OF VARIABLE INTEREST ENTITIES (FORMERLY SPECIAL PURPOSE ENTITIES OR "SPES"). THE COMPANY DOES NOT HAVE ANY VARIABLE INTEREST ENTITIES AS DEFINED BY FIN NO. 46 AND THEREFORE THE INTERPRETATION DID NOT AFFECT THE COMPANY'S FINANCIAL POSITION, RESULTS

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OF OPERATIONS OR CASH FLOWS.

IN DECEMBER 2002, THE FASB ISSUED SFAS NO. 148, "ACCOUNTING FOR STOCK-BASED COMPENSATION - TRANSITION AND DISCLOSURE". SFAS NO. 148 DOES NOT ALTER THE PROVISIONS OF SFAS 123, NOR DOES IT REQUIRE STOCK-BASED COMPENSATION TO BE MEASURED UNDER THE FAIR-VALUE METHOD. RATHER, SFAS 148 PROVIDES ALTERNATIVE TRANSITION METHODS TO COMPANIES THAT ELECT TO EXPENSE STOCK-BASED COMPENSATION USING THE FAIR-VALUE APPROACH UNDER SFAS NO. 123. THE COMPANY WILL CONTINUE TO ACCOUNT FOR STOCK-BASED COMPENSATION IN ACCORDANCE WITH APB NO. 25. THE COMPANY HAS ADOPTED THE DISCLOSURE-ONLY PROVISIONS OF SFAS NO. 148. AS SUCH, THE COMPANY DOES NOT EXPECT THIS STANDARD TO HAVE A MATERIAL IMPACT ON ITS FINANCIAL POSITION OR RESULTS OF OPERATIONS.

IN APRIL 2003, THE FASB ISSUED STATEMENT NO. 149, "AMENDMENT OF STATEMENT NO. 133 ON DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES". THIS STATEMENT AMENDS AND CLARIFIES FINANCIAL ACCOUNTING AND REPORTING FOR DERIVATIVE INSTRUMENTS, INCLUDING CERTAIN DERIVATIVE INSTRUMENTS EMBEDDED IN OTHER CONTRACTS AND FOR HEDGING ACTIVITIES UNDER STATEMENT NO. 133, "ACCOUNTING FOR DERIVATIVES INSTRUMENTS AND HEDGING ACTIVITIES." THE PROVISIONS OF THIS STATEMENT ARE EFFECTIVE FOR ALL DERIVATIVES AND HEDGING ACTIVITIES ENTERED INTO AFTER JUNE 30, 2003. THE COMPANY DID NOT HAVE ANY DERIVATIVES OR HEDGING ACTIVITIES AND THEREFORE THE STANDARD DID NOT AFFECT THE COMPANY'S FINANCIAL POSITION, RESULTS OF OPERATIONS OR CASH FLOWS.

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IN MAY 2003, THE FASB ISSUED SFAS NO. 150 "ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY". SFAS NO. 150 ESTABLISHES STANDARDS ON THE CLASSIFICATION AND MEASUREMENT OF CERTAIN INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY. THE PROVISIONS OF SFAS NO. 150 ARE EFFECTIVE FOR FINANCIAL INSTRUMENTS ENTERED INTO OR MODIFIED AFTER MAY 31, 2002 AND TO ALL OTHER INSTRUMENTS THAT EXIST AS OF THE BEGINNING OF THE FIRST INTERIM FINANCIAL REPORTING PERIOD BEGINNING AFTER JUNE 15, 2003. SFAS NO. 150 DID NOT HAVE A MATERIAL EFFECT ON THE COMPANY'S FINANCIAL STATEMENTS.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

INFORMATION REGARDING FORWARD LOOKING STATEMENTS:

SOME OF THE STATEMENTS IN THIS FORM 10-QSB, INCLUDING THOSE THAT CONTAIN THE WORDS "ANTICIPATE," "BELIEVE," "PLAN," "ESTIMATE," "EXPECT," "SHOULD," "INTEND" AND OTHER SIMILAR EXPRESSIONS, ARE "FORWARD-LOOKING STATEMENTS" WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995. THOSE FORWARD-LOOKING STATEMENTS INVOLVE KNOWN AND UNKNOWN RISKS, UNCERTAINTIES AND OTHER FACTORS THAT MAY CAUSE OUR ACTUAL RESULTS, PERFORMANCE OR ACHIEVEMENTS OR THOSE OF OUR INDUSTRY TO BE MATERIALLY DIFFERENT FROM ANY FUTURE RESULTS, PERFORMANCE OR ACHIEVEMENTS EXPRESSED OR IMPLIED BY THOSE FORWARD-LOOKING STATEMENTS. AMONG THE FACTORS THAT COULD CAUSE ACTUAL RESULTS, PERFORMANCE OR ACHIEVEMENT TO DIFFER MATERIALLY FROM THOSE DESCRIBED OR IMPLIED IN THE FORWARD-LOOKING STATEMENTS ARE GENERAL ECONOMIC CONDITIONS, COMPETITION, POTENTIAL TECHNOLOGY CHANGES, CHANGES IN OR THE LACK OF ANTICIPATED CHANGES IN THE REGULATORY ENVIRONMENT IN VARIOUS COUNTRIES, THE ABILITY TO RAISE ADDITIONAL

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CAPITAL TO FINANCE EXPANSION, THE RISKS INHERENT IN NEW PRODUCT AND SERVICE INTRODUCTIONS AND THE ENTRY INTO NEW GEOGRAPHIC MARKETS AND OTHER FACTORS INCLUDED IN OUR FILINGS WITH THE SECURITIES AND EXCHANGE COMMISSION (THE "SEC"). COPIES OF OUR SEC FILINGS ARE AVAILABLE FROM THE SEC OR MAY BE OBTAINED UPON REQUEST FROM US. WE DO NOT UNDERTAKE ANY OBLIGATION TO UPDATE THE INFORMATION CONTAINED HEREIN, WHICH SPEAKS ONLY AS OF THIS DATE.

GENERAL:

SUNAIR ELECTRONICS, INC. IS A FLORIDA CORPORATION ORGANIZED IN 1956. IT IS ENGAGED IN THE DESIGN, MANUFACTURE AND SALE OF HIGH FREQUENCY SINGLE SIDEBAND COMMUNICATIONS EQUIPMENT AND THE SOFTWARE DEVELOPMENT, DESIGN, INTEGRATION TESTING AND DOCUMENTATION OF C4ISR SYSTEMS UTILIZED FOR LONG RANGE VOICE AND DATA COMMUNICATIONS IN FIXED STATION, MOBILE AND MARINE FOR MILITARY AND GOVERNMENTAL APPLICATIONS.

SUNAIR PRODUCTS AND ENGINEERING CAPABILITIES ARE MARKETED BOTH DOMESTICALLY AND INTERNATIONALLY AND ARE PRIMARILY INTENDED FOR STRATEGIC MILITARY AND OTHER GOVERNMENTAL APPLICATIONS. SALES ARE EXECUTED DIRECT THROUGH SYSTEMS ENGINEERING COMPANIES, WORLDWIDE COMMERCIAL AND FOREIGN GOVERNMENTAL AGENCIES OR DIRECT TO THE U.S. GOVERNMENT.

SUNAIR'S LINE OF EQUIPMENT IS COMPOSED OF PROPRIETARY HF/SSB RADIO EQUIPMENT AND ANCILLARY ITEMS SOLD AS OPERATING UNITS OR COMBINED INTO SOPHISTICATED SYSTEMS THAT MAY INTERFACE WITH WORKSTATIONS, ANTENNAE, POWER SOURCES, MODEMS, MESSAGE SWITCHING DEVICES, CRYPTOGRAPHIC EQUIPMENT SOFTWARE AND THE LIKE PROVIDED BY OTHERS. SUNAIR PRODUCTS EMPLOY ADVANCED SOLID STATE DESIGNS WITH COMPUTER CONTROLLED NETWORKING CAPABILITIES. IN ADDITION, THE COMPANY CUSTOM DESIGNS SYSTEMS INCORPORATING VARIOUS COMBINATIONS OF EQUIPMENT INTO RACKS AND CONTROL CONSOLES THAT MAY INTERFACE WITH VALUE ADDED PRODUCTS AND SYSTEMS OF OTHER MANUFACTURERS.

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LIQUIDITY:

FOR THE FIRST NINE MONTHS ENDED JUNE 30, 2004, THE COMPANY HAD POSITIVE CASH FLOW FROM OPERATIONS OF \$1,010,211 DUE TO PAYMENTS RECEIVED AGAINST INCREASED REVENUES IN THE FOURTH QUARTER OF FISCAL 2003 AND THE SECOND QUARTER OF FISCAL 2004. ACCOUNTS RECEIVABLE DECREASED DUE TO PAYMENTS RECEIVED FOR LARGER SHIPMENTS MADE IN THE SECOND QUARTER OF FISCAL 2004.

CASH FLOWS USED BY INVESTING ACTIVITIES FOR THE NINE MONTHS ENDED JUNE 30, 2004 WERE \$524,372 WHICH CONSISTED OF SHORT TERM INVESTMENTS IN COMMERCIAL PAPER AND PURCHASES OF SMALL QUANTITIES OF COMPUTER EQUIPMENT.

CASH FLOWS PROVIDED BY FINANCING ACTIVITIES FOR THE NINE MONTHS ENDED JUNE 30, 2004 WERE \$176,512 PROVIDED BY THE EXERCISE OF STOCK OPTIONS.

DURING THE FIRST NINE MONTHS OF FISCAL 2004, THE COMPANY HAD SHORT TERM INVESTMENTS AND CASH OR CASH EQUIVALENTS MORE THAN ADEQUATE TO COVER KNOWN REQUIREMENTS, UNFORESEEN EVENTS OR UNCERTAINTIES THAT MIGHT OCCUR. THE COMPANY'S KNOWN REQUIREMENTS CONSIST OF NORMAL OPERATING EXPENSES. DURING THIS NINE MONTH PERIOD, CASH AND CASH EQUIVALENTS HAD AN AVERAGE BALANCE OF \$2,072,000 AS OPPOSED TO AN AVERAGE BALANCE OF \$1,506,000 FOR THE TWELVE MONTHS ENDED SEPTEMBER 30, 2003. CASH EQUIVALENTS ARE TAX EXEMPT MONEY MARKET FUNDS THAT ARE READILY AVAILABLE FOR IMMEDIATE USE SHOULD THE OCCASION ARISE. IT IS ANTICIPATED THAT THE COMPANY WILL REMAIN AS LIQUID DURING FISCAL 2004. THE CURRENT RATIO OF THE COMPANY AS OF JUNE 30, 2004 WAS 33.8 COMPARED TO 13.8 AS OF SEPTEMBER 30,

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2003.

THE COMPANY RECORDS RESERVES FOR INVENTORY SHRINKAGE AND OBSOLESCENCE, WHEN CONSIDERED NECESSARY. AS OF JUNE 30, 2004, ACCOUNTS AND NOTES RECEIVABLE WERE CONSIDERED TO BE FULLY COLLECTIBLE, ACCORDINGLY NO ALLOWANCE FOR DOUBTFUL ACCOUNTS WAS PROVIDED. IF AMOUNTS BECOME UNCOLLECTIBLE, THEY WILL BE CHARGED TO OPERATIONS WHEN THAT DETERMINATION IS MADE.

NON CASH INTERIM RESERVES ARE MAINTAINED TO COVER ITEMS SUCH AS WARRANTY REPAIRS IN PROCESS AND OTHER CHARGES THAT MAY BE IN DISPUTE. ALL MONETARY TRANSACTIONS ARE IN U.S. DOLLARS AND NO LETTERS OF CREDIT INVOLVE FOREIGN EXCHANGE.

CAPITAL RESOURCES:

DURING THE FIRST NINE MONTHS OF FISCAL 2004, \$23,182 WAS SPENT FOR CAPITAL ASSETS. THESE FUNDS WERE PRIMARILY USED FOR NEW COMPUTER HARDWARE. NO EXPENDITURES ARE COMTEMPLATED FOR PLANT EXPANSION OR EXTENSIVE MAINTENANCE IN FISCAL 2004. THE COMPANY HAS NO LONG TERM DEBT, HOWEVER, THE COMPANY MAY INCUR DEBT TO FINANCE ACQUISITIONS. LIABILITIES CONSIST OF CURRENT ACCOUNTS PAYABLE, ACCRUED EXPENSES RELATED TO THE CURRENT ACCOUNTING PERIOD, AND THE CURRENT AND LONG TERM PORTION OF INCOME TAXES PAYABLE.

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RESULTS OF OPERATIONS:

FIRST NINE MONTHS OF FISCAL YEAR ENDED 2004 COMPARED TO FIRST NINE MONTHS OF FISCAL YEAR ENDED 2003.

DURING THE THIRD QUARTER OF THE CURRENT FISCAL YEAR ENDED JUNE 30, 2004, SHIPMENTS OF \$1,420,687 WERE UP 25.1% OR \$285,332 FROM THE SAME QUARTER ONE YEAR AGO DUE TO CONTINUED SHIPMENTS ON A LARGE CONTRACT FROM ONE U.S. CUSTOMER. THE REMAINING SHIPMENTS FOR THIS CONTRACT ARE DUE TO BE INCLUDED IN FOURTH QUARTER SHIPMENTS. SHIPMENTS FOR THE FIRST NINE MONTHS ENDED JUNE 30, 2004 WERE \$5,951,143, UP FROM SHIPMENTS OF \$3,436,094 OR 73.2% FOR THE SAME PERIOD ONE YEAR AGO. SHIPMENTS TO A FOREIGN NAVY AND TO ONE U.S. CUSTOMER ACCOUNTED FOR A LARGE PORTION OF TOTAL SHIPMENTS.

DOMESTIC SHIPMENTS FOR THE FIRST NINE MONTHS OF THE CURRENT FISCAL YEAR WERE \$3,798,949, OR 63.8% OF TOTAL SALES, UP \$911,677 OR 31.6% FOR THE SAME PERIOD ONE YEAR AGO. EXPORT SHIPMENTS FOR THE NINE MONTHS ENDED JUNE 30, 2004 WERE \$2,152,194 OR 36.2% OF TOTAL SALES, UP \$1,603,372 OR 292.1% DUE TO SHIPMENT OF A LARGE CONTRACT RECEIVED IN THE FIRST QUARTER OF FISCAL 2004.

BACKLOG OF \$2,732,000 WAS LOWER AT JUNE 30, 2004 COMPARED TO \$5,494,000 AT JUNE 30, 2003 DUE TO ORDERS DELAYED SLIGHTLY UNTIL THE FOURTH QUARTER OF THE CURRENT FISCAL YEAR. PROJECTED ORDERS REMAINING ON MULTI-YEAR CONTRACTS RECEIVED IN 1999 AND 2000 ARE NOT INCLUDED IN THIS BACKLOG.

COST OF SALES WAS LOWER AT 55.2% OF SALES IN THE FIRST NINE MONTHS OF FISCAL 2004 AS COMPARED TO 58.2% OF SALES FOR THE SAME PERIOD ONE YEAR AGO DUE TO PRODUCT MIX. INVENTORIES DECREASED 2.1% OR \$146,497 FOR THE FIRST NINE MONTHS OF FISCAL 2004 DUE TO CURRENT SHIPMENTS OF INVENTORY PURCHASED IN PRIOR PERIODS. INVENTORY LEVELS ARE ANTICIPATED TO CONTINUE TO DECLINE IN THE CURRENT YEAR DUE TO PROCUREMENTS OF INVENTORY IN PRIOR PERIODS TO MEET FUTURE REQUIREMENTS.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES INCREASED \$287,333 OR 22.7% DUE TO INCREASED RESEARCH AND DEVELOPMENT EXPENDURES FOR PRODUCT DESIGN TO MEET CURRENT AND FUTURE CUSTOMER DEMANDS. EXPENSES CONTINUE TO BE INCURRED FOR EXPANDED

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MARKET EXPOSURE AND INCREASED PRODUCT APPLICATIONS. MARKETING EXPENSES INCREASED DUE TO EXTENSIVE TRAVEL IN THE THIRD QUARTER TO PURSUE EXISTING AND PLANNED PROJECTS IN THE MIDDLE EAST AS WELL AS THE PACIFIC RIM.

INTEREST INCOME DECREASED SLIGHTLY AS LOWER YIELDS CONTINUE ON INVESTMENTS. OTHER INCOME AND EXPENSES INCREASED SLIGHTLY DUE TO REDUCED INCOME ON SCRAP SALES.

SALES FOR THIS REPORTING QUARTER HAVE PRODUCED FAVORABLE RESULTS. WITH THESE LARGE SHIPMENTS OF SUNAIR STANDARD PRODUCTS THE BACKLOG REMAINS AT ABOVE AVERAGE LEVELS DUE TO RECEIPT OF RECURRING DOMESTIC ORDERS.

MARKETING IS FOLLOWING UP ON OPPORTUNITIES FOUND ON A RECENT TRIP THROUGH ASIAN AND MIDDLE EAST COUNTRIES. TWO MAJOR SYSTEMS PROJECTS ARE BEING PURSUED AND PROGRESS IS SHOWING STRONG ORDER CHANCES FOR OUR HF PRODUCTS ON FOUR SHIPBOARD AND FAST PATROL BOAT PROGRAMS IN THOSE GEOGRAPHIC AREAS.

DOMESTIC OPPORTUNITIES RELATED TO DEPARTMENT OF HOMELAND SECURITY (DHS) REQUIREMENTS FOR CONTINGENCY OPERATIONS ARE TAKING SHAPE. PROJECTS HAVING RECURRING NEEDS AND TECHNOLOGY ADVANCEMENTS ARE IN CLOSING STAGES. A MODIFICATION OF A PRIOR ORDERING AGREEMENT WITH AN AGENCY OF THE DHS HAS BEEN FINALIZED AND INCREASED ORDERS ARE ANTICIPATED IN THIS FOURTH QUARTER. SHIPMENTS OF THESE ORDERS WILL BE REALIZED IN FISCAL 2005.

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RESULTS OF OPERATIONS: (CONTINUED)

DURING 1995, IT WAS DETERMINED THAT CONTINUED OPERATIONS OF ITS INTEREST CHARGE-DOMESTIC INTERNATIONAL SALES CORPORATION (IC-DISC) SUBSIDIARY'S ELECTION WAS NO LONGER ADVANTAGEOUS TO THE COMPANY. ACCORDINGLY, THE ELECTION OF THE SUBSIDIARY WAS DISCONTINUED AND ITS RETAINED EARNINGS OF APPROXIMATELY \$3,200,000 WERE DISTRIBUTED TO THE COMPANY. FEDERAL TAX REGULATIONS PROVIDE FOR THE TAXATION OF SUCH DISTRIBUTION OVER A TEN YEAR PERIOD IN EQUAL ANNUAL INCREMENTS. UTILIZING THE MAXIMUM TAX RATES, THE INCOME TAX CONSEQUENCES OF SUCH DISTRIBUTION WILL APPROXIMATE \$122,000 PER YEAR. NO INTEREST IS PAYABLE ON THIS UNPAID PORTION.

SUBSEQUENT EVENTS:

ON AUGUST 9, 2004, THE COMPANY ANNOUNCED THE ACQUISITION OF THE OUTSTANDING STOCK OF PERCIPIA, INC. AND PERCIPIA NETWORKS, INC., COLUMBUS, OHIO, FOR A TOTAL CONSIDERATION OF \$660,000 CASH AND THE ISSUANCE OF 190,000 SHARES OF SUNAIR COMMON STOCK. IN CONJUNCTION WITH THE PURCHASE, SUNAIR WILL LIQUIDATE APPROXIMATELY \$1,600,000 OF PERCIPIA'S DEBT.

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ITEM 3. CONTROLS AND PROCEDURES

(A) EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES. THE TERM "DISCLOSURE CONTROLS AND PROCEDURES" IS DEFINED IN RULE 13a - 15(e) OF THE SECURITIES EXCHANGE ACT OF 1934, OR THE EXCHANGE ACT. THIS TERM REFERS TO THE CONTROLS AND PROCEDURES OF A COMPANY THAT ARE DESIGNED TO ENSURE THAT INFORMATION REQUIRED TO BE DISCLOSED BY A COMPANY IN THE REPORTS THAT IT FILES UNDER THE EXCHANGE ACT IS RECORDED, PROCESSED, SUMMARIZED AND REPORTED WITHIN REQUIRED TIME PERIODS. OUR CHIEF EXECUTIVE OFFICER AND OUR CHIEF FINANCIAL OFFICER HAVE CONCLUDED, BASED ON

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THEIR EVALUATION AS OF JUNE 30, 2004, THAT OUR DISCLOSURE CONTROLS AND PROCEDURES ARE EFFECTIVE FOR RECORDING, PROCESSING, SUMMARIZING AND TIMELY REPORTING THE INFORMATION WE ARE REQUIRED TO DISCLOSE IN OUR REPORTS FILES UNDER THE EXCHANGE ACT.

(B) CHANGES IN INTERNAL CONTROLS OVER FINANCIAL REPORTING. THERE WERE NO CHANGES IN THE COMPANY'S INTERNAL CONTROLS OVER FINANCIAL REPORTING DURING THE LAST FISCAL QUARTER THAT HAVE MATERIALLY AFFECTED, OR ARE REASONABLY LIKELY TO MATERIALLY AFFECT THE COMPANY'S INTERNAL CONTROL OVER FINANCIAL REPORTING.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

NONE

ITEM 2. CHANGES IN SECURITIES

NONE

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

NONE

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

NONE

ITEM 5. OTHER INFORMATION

NONE

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PART II OTHER INFORMATION (CONTINUED)

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) EXHIBITS

14 REVISED CODE OF BUSINESS CONDUCT AND ETHICS

31.1 CERTIFICATION BY CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002.

31.2 CERTIFICATION BY CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002.

32.1 CERTIFICATION BY CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002.

32.2 CERTIFICATION BY CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002.

(B) REPORTS ON FORM 8-K

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ON JULY 29, 2004, THE COMPANY FILED A FORM 8-K DISCLOSING INFORMATION UNDER ITEM 12.

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SIGNATURES

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES AND EXCHANGE ACT OF 1934, THE REGISTRANT HAS DULY CAUSED THIS REPORT TO BE SIGNED ON ITS BEHALF BY THE UNDERSIGNED THEREUNTO DULY AUTHORIZED.

SUNAIR ELECTRONICS, INC.

/S/ JAMES E. LAURENT

DATE: AUGUST 16, 2004

JAMES E. LAURENT, PRINCIPAL
EXECUTIVE OFFICER

/S/ SYNNOTT B. DURHAM

DATE: AUGUST 16, 2004

SYNNOTT B. DURHAM, PRINCIPAL
ACCOUNTING OFFICER

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